

comparable to landline service (which will bring cellular prices down as well).⁸² Now, cellular providers may beat PCS to the punch. GTE plans a PCS-lookalike called Telego that it will begin to deploy this year.⁸³ The Commission may have underestimated potential PCS demand, just as many in the early 1980s underestimated potential cellular demand.

The physical and marketing characteristics of our region will make it a focal point of PCS development, just as it was with cellular. Already ten percent of the experimental licenses for PCS granted in the U.S. are in the San Francisco Bay area, which has under two percent of the nation's population.

Wireless will provide another alternative loop through which telephone customers may obtain their local service. Of all loop alternatives, it may be the ultimate cream-skimming device, since it will attract the more affluent customers. Moreover, there is no reason to think that consumers will automatically connect their wireless loops to the LEC. Wireless providers will be able to take advantage of two-wire competition and multiple

⁸² On March 7, 1994, the FCC amended its mobile service rules to provide symmetrical regulation for all wireless providers. It also announced it would forbear from 1) enforcing tariffing requirements, 2) investigating rates and practices, and 3) reviewing and approving market entry and exit. These actions will speed the entry of PCS and other wireless services into the market. Implementation of Sections 3(n) and 332 of the Communications Act Regulatory Treatment of Mobile Services, Second Report and Order, released March 7, 1994.

⁸³ John J. Keller, "Packet-Phone Service Planned by GTE Corp.", Wall Street Journal, April 19, 1994, at A3.

switch providers. Both LEC and cable fiber networks will be able to transport the landline portion of wireless calls.

6. Interexchange Carriers. The three IXC's who control the interLATA market also have the facilities, even without partnering with CAPs or cable TV providers, to dominate local exchange markets. This possibility is heightened by their oligopolistic behavior in the long distance market.

MCI, recently affiliated with BT, has announced that it will enter the local exchange market. According to published reports, MCI intends to spend \$20 billion to upgrade its network. This includes \$2 billion to assemble a network to provide local service in 20 major markets, including the Bay area. MCI's Chairman, Bert Roberts, also said the company is considering joint ventures and equity investments with cable companies and wireless carriers to help fund the project.⁸⁴ While MCI will apparently start out by being its own CAP, its "goal is eventually to be in every household when the local regulators allow it," according to Gary Parsons, the MCI executive heading up the project.⁸⁵

But the firm most likely to dominate telecommunications is AT&T. AT&T's profits of \$3.8 billion in 1992 made it the most profitable of the world's 500 largest service companies,

⁸⁴ John J. Keller, "MCI Proposes a \$20 Billion Capital Project," Wall Street Journal, January 5, 1994, at A3.

⁸⁵ John Eckhouse, "MCI Plans to Compete in Local Markets," San Francisco Chronicle, January 5, 1994, at 1.

according to Fortune Magazine.⁸⁶ Even if it weren't allowed to acquire McCaw, AT&T is the pre-eminent world provider of telecommunications. States the Berkeley Roundtable's report:

In effect, there appears to be a segmentation emerging in the market between those providers like AT&T and BTNA (British Telecom North America) positioning themselves to become network integrators offering user-customized services and end-end global network management, and the rest who seek refuge in specialized business applications niches. The IECs have several significant assets to draw upon. These include sophisticated billing and accounting resources that can be used strategically to define and serve major customer usage patterns, virtual private network ("VPN") platforms, and, of course, increasingly global connectivity. These network resources permit the IECs to assemble long-term, customer-tailored packages of managed network capabilities (like those AT&T has under Tariff 12), which they hope will lock-in customers over time. Such packages provide a reasonably stable revenue base from which to launch new services and network upgrades -- i.e., exactly the stable opportunity that is denied to the local telcos who lack the capabilities and the regulatory permission. Bar and Borrus, "The Future of Networking in the US," p. 19.

As Peter Huber recounts in his report, "The Geodesic Network II", AT&T currently enjoys market power in equipment manufacturing, interexchange services, international traffic, and some enhanced services.⁸⁷ In the switch manufacturing market,

⁸⁶ "The Global Service 500," Fortune, August 23, 1993, at 160.

⁸⁷ Peter W. Huber, et al. The Geodesic Network II, 1993 Report on Competition in the Telephone Industry (1993). While AT&T has not entered cable, it is actively involved with the

Huber points out that AT&T is one of two equipment manufacturers who together are overwhelmingly dominant in the sale of central office switches, sharing 88% of the market. However, its competitor with whom it shares this 88%, Northern Telecom Ltd., continues to struggle. It reported a \$989.4 million loss through the first three quarters of 1993.⁸⁸

The fulcrum of AT&T's power, however, comes from its long distance network. While some federal regulators continue to insist their policies have brought real competition to long distance, the evidence clearly points the other way. Price competition has dissipated entirely in long distance. Price reductions enjoyed by long distance customers after divestiture were actually funded by reductions in LEC access charges.⁸⁹

The three nationwide, facilities-based carriers, AT&T, MCI, and Sprint, have earned a combined share of over 87 percent of revenues in the interLATA market as of 1992.⁹⁰ AT&T's share

industry. It has shown interest in acting as a network integrator supporting the national interconnection of cable networks. See Amy Harmon, "AT&T Studies Plan to Link Cable Firms," Los Angeles Times, August 28, 1993, at D1.

⁸⁸ Form 10Q of Northern Telecom, Ltd., for quarterly period ended September 30, 1993, p. 4.

⁸⁹ The evidence that long distance price reductions have been funded by LEC access charge reductions was originally developed in Taylor, "Effects of Competitive Entry in U.S. Interstate Toll Markets: An Update," NERA (1992). Access charges paid by AT&T between 1984 and 1994 fell \$10.13 billion. AT&T passed on \$8.22 billion to consumers, keeping the rest.

⁹⁰ Industry Analysis Div., FCC, Long Distance Market Shares: Fourth Quarter 1992, at Table 6 (1993).

stood at about 61 percent of revenues,⁹¹ and about 60 percent of toll minutes.⁹² The combined market power of the three major carriers enables them to extract monopoly rents from consumers. MCI and Sprint do not file earnings separately for their telecommunications lines of business, but AT&T does. And above (p. 30) we show that, normalized for differences in depreciation rates, AT&T's interstate earnings greatly exceed ours. AT&T's intrastate rate of return is routinely two to three times ours.

Despite steadily decreasing access charges, the long distance carriers have raised prices no fewer than four times in the past three years.⁹³ On each occasion, AT&T led the way, and the other two followed. For example, in July 1990, after the first in this series of price hikes, an MCI spokesman expressly stated that MCI would match any future AT&T rate increases.⁹⁴ With respect to the most recent rise in prices, AT&T spokesman Mark Siegel stated: "We have no reason to think [the price hike] won't hold. It's routine. We do it all the time. We've raised

⁹¹ Id.

⁹² Id. at Table 3.

⁹³ On January 24, 1994, AT&T announced another price increase for business customers. "American Telephone & Telegraph: Proposal Filed to Raise Rates on Certain Business Services," Wall St. J., January 25, 1994, at B4.

⁹⁴ See B. Wallace, "MCI Responds to AT&T Rate Hike with Increases," Network World, July 30, 1990, at 14.

prices six times in the past five years and they've all held."⁹⁵ A senior vice president of MCI added: "We move prices in lock step."⁹⁶ MCI issued a statement that "competition has moved away from price. We think there is price stability in the industry now."⁹⁷ Sprint likewise announced, mistakenly, that "customers are looking for more than price.... Sprint's approach is to differentiate itself through product and service offerings, not merely price."⁹⁸

AT&T, MCI and Sprint have leveraged their oligopoly of long distance by calculating volume discounts over both intra- and interLATA traffic, effectively bundling their oligopoly service with their competitive intraLATA service. This bundling of traffic encourages customers to move all of their traffic, including intraLATA, to the IECs to increase the level of discount. While at first only large users were targeted, carriers now have bundled discount plans which target the mid-sized segment of the market, even down to customers with as little as \$50 usage per month.

⁹⁵ D. Dorfman, "Pro Hears Static on Long Distance," USA Today, August 2, 1993, at 2B.

⁹⁶ See C. Skrzycki, "Baby Bells' Dangle Promise of Lower Rates in Push for Long-Distance Service," Washington Post, July 22, 1993, at D9. The MCI spokesman went on to add, "but we move prices down...", although that claim is inconsistent with the evidence.

⁹⁷ See C. Lazzareschi, "AT&T Rate Hikes Takes Aim at Businesses," Los Angeles Times, July 20, 1993, at D1.

⁹⁸ A. Zitner, "AT&T Seeks a Hike in Rates," Boston Globe, July 20, 1993, at 1.

The effect of the long distance oligopoly on Pacific Bell has been dramatic. For outgoing WATS traffic, our revenues climbed steadily from \$74 million per year at divestiture to \$180 million in 1989, the year AT&T's MEGACOM service went to market. Thereafter, Pacific's WATS revenue declined rapidly, generating only \$103 million in revenues in 1993.

For intraLATA 800 traffic, the same is true. IEC 800 services grew 9.4% in 1992, while LEC services declined by 12.6%.⁹⁹ The Frost and Sullivan "800 Service Market" report indicates that local exchange carriers have lost about half of their annual flow of 800 revenues over the past 4 years. The report states:

have seen their ... 800 service ... hemorrhaged, while IECs more and more have been allowed to offer additional attractive switch and dedicated services on an intraLATA as well as interLATA basis.¹⁰⁰

Our experience has been about the same as the rest of the country. In 1988, we had \$187 million in annual revenues from intraLATA 800 service. By 1993, even though the 800 market had grown steadily, our revenues had fallen to \$103 million. Our volume of intraLATA 800 traffic fell from 680 million MOU in 1986 to 480 million in 1993, even though the intrastate 800 market has grown to 2.98 billion MOUs. Most 800 traffic is now carried by

⁹⁹ Frost and Sullivan, 800 Service Market, pp. 4-6.

¹⁰⁰ Id.

AT&T's MEGACOM and Readyline services, and the similar services of MCI and Sprint. Today, AT&T handles 44% of all intrastate 800 traffic, while MCI and Sprint together carry an additional 35%, for a total of 79% for all three IECs. In contrast, we handle only 16%. By comparison, in 1987 the big three IECs together had 47% of the intrastate 800 market, while we held 56%.

AT&T has reasserted its pre-divestiture control over large national customers. Most of these corporations now employ special access in conjunction with their IEC services to bypass our switched services. AT&T's market power in 800 is so complete that the recent introduction of 800 number portability did not negatively affect AT&T's market share. We now carry only a fraction of the intraLATA traffic of Union Bank, SoCal Edison, Unysis, Marriott Corp., Avis, Hertz, American Airlines, DEC, Wang, ARCO, Pepsico, Farmer's Insurance, Prudential Insurance, Goldman Sacks, and many other of AT&T's Tariff 12 customers. AT&T and other IECs only need regulatory authority and interconnection agreements with the LECs to extend full local exchange service to these customers.

Every significant part of our network -- switching, signalling, transport -- AT&T has already replicated, except for one: our twisted pair copper loops. That's no accident; they have no interest in replicating these. Not only are these loops technologically obsolescent, but we are required to sell them below cost. AT&T's preferred loop strategy seems to be wireless, but they do not need to take direct control of McCaw to outflank

us. Wireless providers are free to bundle their loop services with AT&T's long distance service -- although we are not.

AT&T's attempts to defend against allegations by other IXC's that it has market power in California demonstrate, somewhat by accident, its competitive advantage over us in interoffice facility capacity. AT&T estimates that it owns 270 million activated interLATA circuit miles in California.¹⁰¹ Our California network comprises 135.5 million interoffice intraLATA activated circuit miles.

When an overwhelmingly dominant firm, such as AT&T, is present in the industry, it is important for regulators to avoid rules which inadvertently turn over market share to the dominant provider. As the most profitable service corporation in the world at \$3.8 billion in annual profits, AT&T needs no additional, inadvertent funding from regulators to remain competitive.

The relevant market now is the transport of information from anywhere to everywhere. There no longer is a discrete telephone market, or discrete television or wireless market. What exists today is a single market for the transport of any kind of information from any place to any place. Insight Research has already begun defining a single market in which all types of information (voice, video, data) are transported over local loops. It states:

¹⁰¹ See Comments of AT&T Communications of California, Inc., CPUC R.93-04-003, I.93-04-002, February 8, 1994, Appendix ("Assessing Transmission Capacity in California").

When local loop revenue is counted including CATV and wireless services, the local telephone companies' market share for residential customers falls to roughly 70% in 1993 and 65% in 1998.¹⁰²

In a world as bewildering as this, customers will look for one-stop shopping. They will demand that carriers bundle together local telephone service--wireless, wireline or both--with intra- and interstate toll calling. They will want their carrier to handle their video telephony needs, and possibly their cable and interactive television needs. If current rules are not changed, we alone will be legally constrained from meeting those needs. It is time to stop artificially compartmentalizing the market with rules and restrictions that deny customers the choices they seek.

Even the gas and electric utilities have entered the business. As Chairman Hundt wrote recently,

Electric and gas companies are well-positioned to become facilities-based competitors in telecommunications markets because of their extensive rights-of-way. Indeed, electric utilities already have made access to their rights-of-way available to interexchange common carriers for the purpose of installing fiber optic cables. According to a 1993 estimate prepared by the FCC's Industry Analysis Division, interexchange carriers have installed over 100,000 fiber miles (4,700 miles of cable) within electric utility rights-of-way (e.g., buried next to

¹⁰² "Competition in the Local Loop: Telcos, Cable TV, and Wireless in the Emerging Telecommunications Network 1993-1998," Insight Reports, Insight Research, February 1993, at 25.

transmission towers) throughout the country.¹⁰³

San Diego Gas and Electric (SDG&E) and Teleport have a request before the CPUC (scheduled for the May 25, 1994 conference) that requests permission for Teleport to use SDG&E's facilities and its internal telecommunications network.

Networks exist today that require only the impending completion of state authority and interconnection arrangements to enable them to compete for local exchange traffic, belying any ability on the part of local exchange carriers to dominate telecommunications through network architecture design. Dominance is equally unlikely in view of the fact the local exchange carriers are boxed into one corner of the market, neither able to leave the LATA nor provide cable television.

Transition Issue 1b: What criteria if any should be used for determining when reduced or streamlined regulation for price cap LECs should take effect?

The Commission cites the USTA Access Reform Proposal to create transport, switching, and public policy baskets, as well as a basket designated as "other" to include interexchange services and rate elements that do not fit in the other three baskets. Notice, para. 39. The USTA proposal is a good place to start.

¹⁰³ Letter from Reed E. Hundt, Chairman, FCC, to Edward J. Markey, U.S. House of Representatives, March 7, 1994, p. 2.

The USTA proposal begins the process of limiting regulation to defined markets in which it is beneficial: those in which one provider has market power. The object of controlling market power is to prevent the charging of supracompetitive, or high, prices. It is an irony that most of the recent concern in regulatory proceedings -- particularly the concern of competitors -- has been that the dominant firm's prices may be too low.

The process of defining a relevant market (typically by product or service and/or geographic area) and analyzing market power (or elasticities of supply and demand) isn't a new one. Geographically, competitive markets are defined by the reach of our competitors. Although our competitors' reach (for example, their fiber rings) doesn't necessarily correspond exactly to our wire centers, the wire center is the most practical place to begin.¹⁰⁴ The next step is to analyze market power. When all is said and done, defining "market power" is equally simple: it is "the ability to restrict output or raise price over what would prevail in a competitive market, and maintain it over time."¹⁰⁵ Market power and market share are different things. As Michael L. Katz and Robert D. Willig wrote just before divestiture,

¹⁰⁴ In many places, we do not know where our competitors' wires or switches are. See Map 1 (following p. 70). The Commission should require them to file such data.

¹⁰⁵ Competition, Rate Deregulation and the Commission's Policies Relating to the Provision of Cable Television Service, 5 FCC Rcd. 4962, 4968 n.19 (1990).

"[c]omparing the market shares of AT&T and its competitors also conveys information -- but, contrary to what some have claimed, it isn't by itself a sufficient test. The market shares of the non-AT&T carriers are relevant only to the extent that they demonstrate the carriers' ability to expand their output significantly in response to an AT&T price increase, and a group of firms may have this potential even if their combined market share is small."¹⁰⁶

Similarly, in Docket 90-132, concerning competition in the interexchange market, the Commission recognized that "market share alone is not necessarily a reliable measure of competition, particularly in markets with high supply and demand elasticities."¹⁰⁷ The Commission found that "the relative supply capabilities of competitors in the market" may be "more indicative of the level of competition" than are market share data.¹⁰⁸ The Commission stated:

Relative supply capabilities allow an assessment of supply elasticity, which refers to the ability of competitors in a market to meet additional demand, beyond that which they currently meet. Supply elasticities are important because even if one company enjoys a very high market share, it will be constrained from raising its prices above

¹⁰⁶ "The Case For Freeing AT&T," Regulation, v. 7, no. 4 (July/August 1983), pp. 48-49.

¹⁰⁷ Competition in the Interstate Interexchange Marketplace, 6 FCC Rcd. 5880, para. 51 (1991).

¹⁰⁸ Competition in the Interstate Interexchange Marketplace, 5 FCC Rcd. 2627, para. 51 (1990).

cost if its competitors have, or could easily acquire, the capacity to serve its customers at current price levels.¹⁰⁹

The ability to raise price profitably above the competitive level requires that there be inadequate substitutes for the LEC service and that substitutes not be readily supplied in response to a profitable opportunity. The lack of current substitutes can be remedied if there is easy entry to the market. In analyzing mergers, the U.S. Department of Justice considers a market to be competitive if entry is expected to occur within two years.¹¹⁰

Our competitors' lack of significant market share in less attractive markets, and the LECs' high market shares in those markets, do not provide evidence of any LEC market power. Where firms, such as the LECs, have been "compelled to charge uniform prices in different product or geographical markets despite the different costs of serving the market," it is "improper to infer market power simply from observing the large market share."¹¹¹

In Docket 91-141, the Commission stated that satisfaction of either of the conditions that trigger permission for zone pricing discounts "will provide marketplace evidence

¹⁰⁹ Id.

¹¹⁰ 1992 Merger Guidelines, Section 3.2, reprinted at 4 Trade Reg. Rpt. (CCH) Para. 13,104.

¹¹¹ William M. Landes and Richard A. Posner, "Market Power in Antitrust Cases," 94 Harv. L. Rev. 937, 976 (1981).

that the LECs' expanded interconnection tariffs provide a viable competitive opportunity."¹¹² The "competitive opportunity" test is consistent with the Commission's market power analysis in Docket 90-132, discussed above.

Where a properly defined market is competitive, and we lack market power due to the supply and demand elasticities of that market, little or no regulation is warranted. The cost of such regulation -- in lost efficiencies and foregone consumer welfare -- would be too steep. In the markets where we have shown a significant loss of market share to MFS and TCG, for example (above, p. 78), those consumers who remain are being forced by outdated pricing rules to pay too much.

The USTA proposal provides criteria for determining which markets are competitive, and separating them from fully regulated markets to prevent cross-subsidies. The criteria define a wire center as an initial market area (IMA), a transitional market area (TMA) or a competitive market area (CMA). A wire center would be reclassified as a TMA if a competitor were present that could provide substitute carrier access services or if expanded interconnection were present. A TMA wire center would be classified as a CMA if it meets both of the following criteria:

- (i) a sufficiently large portion of the customer demand in the wire center has an alternative source of supply available, and

¹¹² Expanded Interconnection with Local Telephone Company Facilities, Transport Phase I, 8 FCC Rcd. 7374, para. 118 (1993) (emphasis added).

- (ii) a sufficiently large number of customers are actively seeking alternative sources of supply through solicitation of bids or construction of their own facilities.

A TMA wire center would receive limited additional pricing flexibility: price changes for individual TMA categories would have an annual upper limit of 5 percent and a lower limit of 15 percent, adjusted for the change in the price cap index (PCI). In addition, LECs would be permitted to respond to a request for proposal (RFP) with a contract designed to meet the specific requirements of the customer. Prices in CMA wire centers would no longer be subject to the price cap rules but would remain regulated as Title II communications services. Contract-based pricing would be permitted in a CMA. Prices and quantities in TMAs and CMA wire centers would be removed from the service band index (SBI) calculations for services provided in IMAs to avoid cross-subsidy.

The USTA proposal adequately defines relevant markets, and states an easily-applied test of market power to gauge how much regulation is justified. The proposal doesn't increase the ability to cross-subsidize, because competitively priced services are brought out from under the price cap. Thus the LEC cannot raise prices of noncompetitive or partially competitive services to fund below-cost pricing of services in a CMA.

The USTA proposal is consistent with pure price cap regulation. In free markets, firms price competitive services at optimal levels. Competition penalizes cross-subsidies between

competitive services.¹¹³ Pure price cap regulation -- or any form of regulation that breaks the link between reported costs and prices -- would give carriers the same incentive not to cross-subsidize as a competitive firm. The elimination of sharing, the basket/band simplification and the pricing flexibility that we propose would increase our ability to send the right pricing signals by pricing services based on supply, demand, and cost, while at the same time reducing the ability and incentive to act anticompetitively.

The USTA proposal, however, is only a start. The only service we provide that our competitors haven't completely replicated yet is the loop. One reason for this is that cross-subsidies flow to the loop, not from it. In the long run there should be only two price cap baskets. Explicit and implicit subsidies would be in one basket. Services that are subject to high elasticities of supply and demand, but are not fully competitive, would comprise another basket. Services offered in competitive markets would be removed from price cap regulation altogether.

¹¹³ In 1979, two economists analyzed the regulatory regime under which a firm's overall price level only is constrained; that is, when there are no additional constraints on individual prices or sets of prices (e.g., baskets). They found that the firm under this regulatory regime will tend, in the long term, to price efficiently. Ultimately, the prices that maximize economic efficiency also maximize the firm's profits. Thus, regulatory intervention in setting individual rates cannot be justified on the basis of general economic efficiency. I. Vogelsang and J. Finsinger, "A Regulatory Adjustment Process for Optimal Pricing by Multiproduct Monopoly Firms," *Bell Journal of Economics* 10(1), 1979 at 157-71; see also Ingo Vogelsang, Price Cap Regulation of Telecommunications Services: A Long-Run Approach (Santa Monica, Calif., 1988), at vii-ix, 24-25.

If that and the myriad of state and federal rules designed to allocate costs between competitive services and noncompetitive services and between affiliates do not provide enough comfort, then partially competitive services can be grouped in a minimal number of baskets according to the degree of competition they face.¹¹⁴ But competitive services still should be excluded from regulation. If regulated services are subject to price caps, and there is no sharing, there is no potential or incentive for cross-subsidy.

Within the price cap baskets, moreover, there is no need for banding. If services are grouped based on the extent of competition, pricing flexibility, with its benefits to consumers, can be extended to all services.

Transition Issue 1c: In what circumstances will a LEC no longer control essential "bottleneck" facilities for some or all of its services? How will the Commission be able to identify these circumstances in practice?

As we have shown above, all of our facilities with one exception can be replicated, and are being replicated, by competitors. The only exception is the twisted-pair copper loop. The principal reason it's not being replicated is that it's no longer a source of market power.

Some have argued that there is still life left in copper loops. These arguments are typically made to convince

¹¹⁴ For example, in California, intrastate services are grouped in three categories: for fully competitive services, partially competitive services, and monopoly services.

regulators to limit LEC investment in broadband facilities via the public switched network. It's true that copper can continue to provide telephone services, including ISDN, and contribute to the ubiquity of the public switched network. However, twisted pair copper fails to satisfy two broad sets of consumer demands in the future: breadth, and mobility.

Twisted pair copper can't provide the services the alternative broadband networks will offer. Dr. Frank Spitznogle, of Strategic Focus, Inc. in Colorado, writing in the June, 1993 edition of Telestrategies Insight, agrees:

To large business users, the Competitive Access Providers' (CAPs) all-fiber networks have rendered LEC copper in the ground and local digital switches obsolete.
Telestrategies Insight, June, 1993, p. 12.

In addition to its relatively higher deployment and maintenance costs, copper can't satisfactorily carry video, even with the recent improvements in video compression. While copper can apparently carry between one and four television channels at any time, competing broadband networks now appear to be approaching 1,000 channels. "Channel surfers" will have no interest in the copper offering. Further, certain types of video animations, including the Disney films, cannot be compressed and thus will never be able to be carried over copper.

The convergence of television with telephony will make customers demand broadband capabilities all the way to their premises. Our copper loops provide limited commercial-grade broadband capabilities. With the emergence of alternative

broadband networks, the existing copper "bottleneck" is today obsolete for many applications. Only coaxial cable -- which passes 90% of American's homes in the form of cable TV loops -- is now positioned to do that.

Second, the twisted pair copper loop also fails to meet customer demands for mobility, as the explosion of wireless technology (above, p. 91) demonstrates.

As a practical matter, the Commission need not wait for cable and telephony service to merge or wireless services to capture the majority of the mass market before celebrating the death of the bottleneck. Starting in mid-1994, we, in conjunction with interested third party access providers, will unbundle and test key interconnection arrangements for providers to use to provide local exchange competition. These interconnection arrangements will include a variety of local loops, or "links", unbundled from Pacific's end office switches. Also unbundled will be interconnection to our switch via "ports". A number of switch features, such as Call Forwarding and CLASS features, may be purchased with ports. Certain support services, such as Directory Assistance and Operator Assistance, will also be made available to our competitors. They are described in more detail in our filing with the CPUC.¹¹⁵

¹¹⁵ See Opening Comments of Pacific Bell, R. 93-04-003, filed February 8, 1994, and Reply Comments of Pacific Bell, R. 93-04-003, filed March 31, 1994.

Links and ports are expected to be Category I services and thus subject to full price regulation by the CPUC.

Other firms -- the established IXC's and cable TV providers -- own the technical capability to compete across the board with us today if all state regulatory commissions allowed it. But our link and port offerings, combined with mandatory switched and special interconnection, the switching features unbundled as part of ONA, and the whole array of services and facilities already available for resale by our competitors the IXC's, CAP's, and cable TV providers, will allow any provider to provide retail end-to-end service in competition with us even if they own little network capability in their own right. We intend to run several different tests with different industry participants. Given the variety of industry participants and their unique applications, custom technical and contractual arrangements will probably be necessary. The length of the tests and trials will be individually negotiated with each provider. Following the conclusion of each trial, service may need to stay in place pending a permanent offering. Pacific has filed an Application with the CPUC to grant, on an ex parte basis, interim CPCNs to other providers to permit them to offer local exchange service in the tests and trials.

Transition Issue 1d: What ability do CAP's and others have to compete with the LEC's? What data indicate the actual and potential competition from CAP's and other providers? For example, such data may include the CAP's' profit levels, stock price trends, revenues, or other measures which reflect the CAP's' ability to compete.

We have discussed this above, at p. 76.

Transition Issue 1e: What impact should price cap LEC entry into related industries (e.g., cable TV) and BOC entry into inter-LATA marketplaces have on the LEC price cap plan?

The opening of new markets for us underscores the need for pure price cap regulation. First, by such means as sharing, unrealistic depreciation allowances, and rules that prevent us from pricing flexibly or responding to competition, the current price cap rules discourage investment in networks used to provide regulated services. They penalize LECs for reinvesting profits in the business we know best. We have a duty to shareholders to seek the maximum return on the dollars they have invested in us. The current price cap and depreciation rules enhance the relative attractiveness of nonregulated lines of business. Reforming the rules to remove disincentives to investing in our core business would ensure that we enter other lines of business for reasons that will maximize consumer welfare.

Second, pure price cap rules would limit both the incentive and the ability to cross-subsidize nonregulated lines of business with regulated business. As Alfred E. Kahn testified in Bell Atlantic's successful cable cross-ownership litigation:

[Price cap] plans, by further weakening any previous assurances of automatic recovery from less competitive services of net revenue losses from competitive ones, have the effect of weakening any incentive or ability the telephone companies may have had to cross-subsidize competitive services at the expense of others less subject to competition. Indeed, prevention of cross-subsidies has been one central, explicit reason for the adoption of these reforms.... Under the various forms of incentive regulation, the incurrence of

"losses" on competitive business would simply decrease their profits. Significantly, even [The National Cable Television Association] concedes that a pure price cap arrangement would "reduce or eliminate the incentive to shift costs to regulated services."¹¹⁶

Third, current rules and marketplace realities assure that we would present no unfair threat to current players in the cable TV and interLATA markets. The Commission has already established Part 64 cost allocation rules to separate the costs of regulated and deregulated services. And the market also precludes cross-subsidies in a variety of ways.

Our primary sources of contribution over past years have been from toll and access charges. Both of these markets are increasingly competitive today, and will be more so when the CPUC removes the ban on intraLATA competition. The one facility our competitors seem in no hurry to duplicate -- our twisted pair copper -- is priced below any legitimate measure of cost, and is the beneficiary, rather than the source of, cross-subsidies.¹¹⁷

In addition, as Dr. Kahn noted in his affidavit in the Bell Atlantic litigation, to be successful, a cross-subsidy strategy must be able to preclude competitors from the marketplace so that the cross-subsidy strategy can recoup its investment.¹¹⁸ Even

¹¹⁶ Reply Affidavit of Alfred E. Kahn, submitted in C&P Telephone Company v. U.S., Civil Action No. 92-1751-A (N.D.Va. 1993) ("Kahn Affidavit"), pp. 6-7.

¹¹⁷ Indeed, once local competition is authorized, intervenors may complain that this subsidy for consumers has anti-competitive effects.

¹¹⁸ Kahn Affidavit, p. 8.

today, however, prior to full legal competitive entry, this strategy is obviously unworkable. Billions of dollars are flowing into telecommunications. The vehicles for this investment are the world's largest corporations, which are getting bigger daily. AT&T is one of the world's largest and most profitable corporations. British Telecom and MCI were both large even before they aligned. Time Warner was one of the largest entertainment conglomerates in the world before it sold a 25% stake to US West. The idea that we could use our obsolescent copper loops to run any of these consortia out of the Information Age is absurd.

The cross-subsidy argument is also wearing thin with the courts. In the D.C. Circuit's recent opinion affirming the lifting of the information services ban, the cross-subsidy issue was revisited in depth. The Court there rejected the contention that the RBOCs were in a position to discriminate or cross-subsidize to the detriment of unaffiliated enhanced service providers. The court noted that: "Large information service providers not only can but already do bypass the BOCs by constructing private networks. Two of the appellants' primary experts acknowledge the ability of high-volume providers to use bypass to defeat any discrimination attempts." Added the court:

While some providers may well be too small to defeat discrimination this way, it is hard to see what advantage a BOC could draw from beating down small rivals whose customers could readily shift to the BOC's larger competitors.

U.S. v. Western Electric Co., 993 F.2d 1572, 1578 (D.C. Cir. 1993). The court noted approvingly Professor Kahn's discussion of the positive effects of price cap regulation, agreeing that price caps reduce "any BOC's ability to shift costs from unregulated to regulated activities, because the increase in costs for the regulated activity does not automatically cause an increase in the legal rate ceiling." Id. at 1580.

Transition Issue 2: What regulatory methods for reducing price cap regulation or streamlined regulation should be adopted for LEC services as those services become subject to greater competition?

We have discussed this above, at p. 100.

Transition Issue 3: Whether and how should the Commission schedule revisions in the composition of price cap baskets as local exchange access competition develops? Should the Commission adopt a set of procedures that would rebalance baskets in response to specified changes in market conditions?

We have discussed this above, at p. 24.

Transition Issue 4: Whether and how should the Commission revise its monitoring of LEC service quality, network reliability, and infrastructure as part of any transition plan?

The presence of competition calls into question the meaningfulness of service quality monitoring. Where there is more than one provider for a service, market forces will encourage superior service quality. Alternatively, customers may want the option of paying less for services of lower quality. Competition stimulates infrastructure development as all competitors build and maintain networks capable of delivering state of the art services, in a reliable way. Monitoring the